the reconditioning was undertaken not to permit the pipeline to continue to operate during its initial estimated useful life, but rather to enable the pipeline segments to begin a new period of expected life. The court also found that the work was done as part of an overall plan of rehabilitation which was significant in relation to petitioner's overall operations and available funds. It reversed the district court's findings to the contrary as clearly erroneous, and held that the costs in question were capital expenditures to be depreciated over the new period of expected life of the pipeline. (Pet. App. B 47, 50-51.) The court further held (Pet. App. B 52) that "a reallocation of the expenditures in question between the two or three accounts cannot under the circumstances here present be regarded as contrary to section 446 [relating to methods of accounting] or to violate its purpose."

II. *The absorption plant processes which yield saleable condensate*

Petitioner and the Union Pacific Railroad are 51 and 49 percent owners, respectively, of the reserves in the Church Buttes gas field in Wyoming. The wet gas produced from the field contains liquid hydrocarbons and water in a vapor state. Petitioner does not sell this wet gas at the wellhead. Rather, the gas is piped directly from the wells to a central separation and absorption plant owned by petitioner and Union Pacific. About 63 percent of the liquid hydrocarbons condenses naturally as the wet gas flows from the wells to the plant, is separated by a mechanical process at the plant's Inlet Scrubber, stored, and sold to refiners. The Inlet Scrub-

ber is a mechanical or gravity separator of a type commonly found at the wellhead. (Pet. App. A 31-32; Pet. App. B 53.)

The gas entering the plant after passing the Inlet Scrubber still contains liquefiable hydrocarbons, and these are reduced to condensate and removed from the gas in two stages. First, oils absorb the liquefiable hydrocarbons, thus removing them from the gas; then the absorbed hydrocarbons are removed from the oil by boiling them off with heat, reduced to a condensate, stored, and sold as crude petroleum to refineries. No chemical change is involved in these processes. The water vapor is also removed from the gas by absorption processes. The removal of the condensate and water leaves a dry gas which is suitable for transmission by pipeline and used as a heating fuel. (Pet. App. A 33-34; Pet. App. B 53-54.)

In the case of oil and gas wells, Section 613(a) and (b)(1) of the Internal Revenue Code of 1954, Appendix, *infra*, pp. 16-17, as effective during the years in issue, authorized a depletion deduction of 27½ percent of the "gross income from the property." The question in the case at bar is what constituted petitioner's "gross income from the property" with respect to the condensate derived from the wet gas by absorption processes. Treasury Regulations on Income Tax (1954 Code), Section 1.613-3(a), Appendix, *infra*, pp. 18-19, provides that:

> In the case of oil and gas wells, "gross income from the property," * * * means the amount for which the taxpayer sells the oil or gas in the im-

> mediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

The rulings of the courts below turned upon their conclusions as to whether the absorption processes involved were conversion (manufacturing) processes, or were simply part of the extractive phase of petitioner's operations. The district court, taking the view that the absorption processes were part of petitioner's extractive operations, ruled that petitioner's depletable "gross income from the property [condensate produced by absorption]" was its gross sales thereof (Pet. App. A 36-37). Reversing, the court of appeals concluded that the absorption processes were conversion processes yielding marketable products, not extractive processes. It accordingly held that the depletion base of the condensate was not petitioner's gross sales, but a lesser constructive amount derived from representative market or field prices for the wet gas petitioner extracted from the ground.[2] (Pet. App. B 56.)

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[2] The U.S. Geological Survey, which administers petitioner's Church Buttes federal leases, requires petitioner to pay royalties to the government based on values of gas and condensate after the completion of processing in the plant, on the theory that the plant is not a manufacturing facility but merely a production facility associated with extraction of the wet gas from the ground (Pet. App. A 34; Pet. App. B 54).

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

I. *Petitioner's expenditures for reconditioning and reconstructing portions of its pipeline system*

1. Section 162(a) of the Internal Revenue Code of 1954, Appendix, *infra*, p. 15, authorizes the deduction of ordinary and necessary business expenses. Treasury Regulations on Income Tax (1954 Code), Section 1.162-4, Appendix, *infra*, p. 17, characterizes as deductible business expense, subject to certain provisos, the "cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition * * *." Section 263(a) of the Code, Appendix, *infra*, p. 15, provides that expenditures are capital in nature and nondeductible where they are "for permanent improvements or betterments made to increase the value of any property," or are "expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." These limitations are elaborated in Regulations under Code Sections 162 and 263(a). Section 1.162-4, Appendix, *infra*, p. 17, classifies as nondeductible the cost of repairs "in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property * * *." Somewhat similarly, Section 1.263(a)-1(b), Appendix, *infra*, pp. 17-18, provides that expenditures may not be deducted if they

"add to the value, or substantially prolong the useful life, of property * * *."

The court of appeals here determined that the pipeline segments involved had reached or passed the period initially assigned as their useful life; that the reconstruction and reconditioning work was done under a general program of rehabilitation; that the program was significant in relation to petitioner's operations; and that the result of the work was to start another life span for the reconditioned segments. Given the court's findings, its conclusion that the costs in question are capital expenditures is the only conclusion compatible with the terms of Sections 162, 263, and the regulations thereunder. Petitioner does not argue to the contrary; it has simply ignored all of these provisions.

Petitioner instead relies on Section 446, Appendix, *infra*, pp. 15-16, which provides as a general rule that taxable income shall be computed under the method of accounting regularly employed by the taxpayer in keeping its books, but further provides that if the taxpayer's method does not clearly reflect income, the computation of taxable income shall be made in such manner as does clearly reflect income. The result is the same, however, whether the question here is approached under Sections 162 and 263, or under Section 446. The findings of the court of appeals that the costs in question were part of a single plan of rehabilitation, were significant in relation to petitioner's operations, and enabled the pipeline segments to begin a new period of useful life preclude the conclusion that the expensing

of such costs would clearly reflect petitioner's income within the meaning of Section 446.[2]

2. There is no conflict, even in principle, with *Cincinnati, New Orleans & Texas Ry. Co.* v. *United States*, 424 F. 2d 563 (Ct. Cl.), or *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918 (C.A. 7), as petitioner contends (Pet. 11-13). Both arose on wholly different facts. The *Cincinnati, New Orleans* case involved the railroad's practice of expensing items of property costing less than $500, in accordance with Interstate Commerce Commission regulations.[3] In *Van Pickerill*, the issue was whether the taxpayer's method of accounting for its inventory of bulk whiskey clearly reflected its income, where taxes, insurance premiums and storage costs were deducted currently, rather than added to inventory. In each case it was held that the taxpayer's method of accounting was proper because, among other things, the taxpayer was able to show that its taxable income would have been approximately the same whether it used its own method of accounting or the

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[2] Petitioner claims (Pet. 6, 12) that its practice was in accordance with generally accepted accounting principles and with Federal Power Commission and Utah Public Service Commission requirements. But there was testimony below to the contrary (see p. 62 of the record appendix in the court of appeals), and, in any event, it is settled that the rules of accounting prescribed by a regulatory agency are not binding for tax purposes. See *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552; *Commissioner* v. *Lincoln Savings and Loan Assn.*, 403 U.S. 345.

[3] The same regulations prohibit expense treatment where two or more items are purchased as part of a single plan, and the total cost of all items purchased is $500 or more. See *Cincinnati, New Orleans & Texas Ry. Co.* v. *United States*, *supra*, 424 F. 2d at 565-566.

method proposed by the government. Where, as here, on the other hand, the expenditure is found to be substantial in relation to the taxpayer's operations, its treatment as a current expense, rather than as a capital expenditure, necessarily will have a material effect on the computation of taxable income.[4]

II. *Depletion on the condensate produced by the absorption processes*

The depletion allowance is "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit," and "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312. A taxpayer must look solely to income derived from extraction for a return of his capital through the depletion allowance. *Palmer* v. *Bender*, 287 U.S. 551, 557; *Commissioner* v. *Southwest Expl. Co.*, *supra* at 314. As this Court explained in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 88, depletion is not designed "to recompense for costs of recovery but for exhaustion of mineral assets alone"; a taxpayer is not entitled, "in addition to a depletion allowance on his

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[4] Petitioner, without elaboration, asserts conflict by way of footnote (Pet. 11, n. 1) with *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275, and *Marsh Fork Coal Co.* v. *Lucas*, 42 F. 2d 83 (C.A. 4). *Fort Howard* noted that the taxpayer's method was not in derogation of any provision of the Internal Revenue Code, and *Marsh Fork* stressed that successive Treasury Regulations had permitted the accounting practice involved. These factors are not present here.

minerals, [to] a similar allowance on his manufacturing costs, including depreciation on his manufacturing plant, machinery and facilities." In line with these decisions, it is settled that the depletable "gross income from the property" of an oil and gas producer is "only so much of the proceeds from the sale of the gas as he would have received had he sold the gas at the wellhead." *Hugoton Production Co.* v. *United States*, 315 F. 2d 868, 869 (Ct. Cl.); *Brea Cannon Oil Co.* v. *Commissioner*, 77 F. 2d 67 (C.A. 9); *Consumer Natural Gas Co.* v. *Commissioner*, 78 F. 2d 161 (C.A. 2).

In *Shamrock Oil & Gas Corp.* v. *Commissioner*, 346 F. 2d 377 (C.A. 5), the taxpayer, like petitioner, applied absorption and other processes to its raw wet gas, and contended that the values added by these processes were part of its depletable income. The Fifth Circuit rejected this contention, concluding that the taxpayer was entitled to depletion only on the basis of a representative market or field price for its raw gas. It specifically held that the absorption process was a conversion or manufacturing process, stating (346 F. 2d at 380):

> Although the absorption process here may have been essential from a marketing viewpoint, it was in no sense essential to *production*, any more than it can be said that the fractionation process was essential to production. Both were designed and operated to separate the raw gas into its various component parts for marketing purposes. What Shamrock produced was raw gas.[5]

[5] Proposed Treasury Regulations, 33 Fed. Reg., Part 10, pp. 14707-14708, Section 1.613-3(a)(3)(i), defines conversion or manu-

It is apparent from the quoted language that *Shamrock* cannot be distinguished on the ground that the taxpayer in that case proceeded to fractionate its liquefied hydrocarbons into gasoline and other products. Nor would any such distinction be permitted by *Cannelton*, where it was held that there can be no discrimination between mineral producers as to the point where their extractive processes end; they end where the ordinary mineral operator is ready to ship and sell his crude mineral, regardless of the extent, if any, to which they or other producers may thereafter apply manufacturing processes to their minerals. Cf. Breeding & Burton, *Income Taxation of Oil and Gas Production*, par. 11.10, p. 1112. There is thus no basis for petitioner's claims of conflict (Pet. 17-22) with the principles of *Cannelton* and with the decision in *Shamrock*.

Moreover, the Fifth Circuit in *Shamrock* properly distinguished cases where the absorption processes were bound up with and essential to production. See, *e.g.*, *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750 (C.A. 5); *Scofield* v. *La Gloria Oil and Gas Co.*, 268 F. 2d 699 (C.A. 5). In those cases, as explained in *Shamrock* (346 F. 2d at 379-380), "the absorption process constituted an indispensable part of the severance of the raw gas produced. * * * [T]he dry gas remaining was injected back into the reservoir in order to maintain pressure. The cycling plants, which contained absorption facilities, were essential for continuing production of gas from the wells." That situation does not obtain in the instant case. The absorption processes here were

facturing processes, in the case of gas, as including absorption processes.

not "an indispensable part of the severance of the raw gas produced." They were applied to the raw gas in a central plant, after it had been transported as far as five miles from the wellhead (Pet. App. A-31), in order to produce petitioner's marketable condensate and dry gas.[6]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

GRANT W. WIPRUD,
ISSIE L. JENKINS,
Attorneys.

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[6] Petitioner is not helped by the fact that the separation of liquid hydrocarbons from the wet gas by the Inlet Scrubber is treated as part of extraction. Such separation is a purely mechanical matter, usually accomplished at the wellhead, of draining off condensate which has formed naturally, without the application of any process.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * *

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

* * * * *

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * * * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

SEC. 613. [1964 ed.] PERCENTAGE DEPLETION.

(a) [as amended by Sec. 13(c), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 1034] *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allow-

ance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.162-4 *Repairs.*

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

§ 1.263(a)-1 *Capital expenditures; in general.*

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or better-

ments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162-4.

* * * * * *

§ 1.613-3 *Gross income from the property.*

(a). *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field

price of the oil or gas before conversion or transportation.

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